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TAGS: EFIN ECON IC
SUBJECT: INTERNATIONAL MEDIA CONTINUES TO DISSECT ICELANDIC ECONOMY, THOUGH ANALSYSTS NOT AGREED ON WHETHER IMBALANCES REPRESENT SERIOUS THREAT TO ECONOMIC STABILITY

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¶1. Summary. Over the past two months, credit rating agencies and other international financial firms have released a torrent of reports raising questions about the state of the Icelandic economy and the activities and stability of Iceland's major banks. These reports have been widely covered in the international financial press, causing a marked drop in the value of the Icelandic Krona and of shares listed on the Icelandic stock exchange. This new level of scrutiny is also making it more challenging for Icelandic banks to secure financing on international markets. There is no question that certain imbalances have emerged in the Icelandic economy, including a high current account deficit, high inflation and high private sector debt levels. It remains an open question, however, whether these imbalances render Iceland particularly vulnerable to an economic crisis. Financial analysts have articulately argued both sides of the case. End summary.

¶2. The release of a report by the credit rating agency Fitch in mid-February expressing concerns about overly risky practices on the part of Icelandic banks and troubling signs for the Icelandic economy provoked a sudden drop in the value of the Icelandic Krona and the main stock exchange index (the ICEX). The Fitch report has subsequently been followed by a slew of other reports from international rating firms such as Moody's and Standard and Poor's, and from investment and commercial banks including Merrill Lynch, Morgan Stanley and JP Morgan. Speculation and analysis about Iceland's economy now appears almost daily in the international press, including leading publications such as the Wall Street Journal, Financial Times, and The Economist.

¶3. The various reports run the gamut from concluding that the Icelandic financial sky is falling to the view that despite a few economic indicators being out of balance, the Icelandic economy is sound and the negative prognostications wildly exaggerated. In any case, just the fact that the Icelandic economy is now under the microscope -- fairly or unfairly -- has made the domestic and international markets jittery about the Icelandic Krona and Icelandic securities. As a result, the Krona has fallen 15 percent against the dollar since the beginning of the year, and the stock exchange index has dropped 18 percent since reaching an all-time high on February 16.

The Case for Looming Economic Difficulty

¶4. The main areas of economic concern most often cited by analysts are Iceland's large current account deficit (some 16 percent of GDP), high inflation (4.4 percent), high personal indebtedness, and high levels of short-term foreign debt carried by Iceland's three major banks -- debt that the banks are now having some difficulty rolling over except by agreeing to pay higher interest rates. In addition, some analysts maintain that Iceland's major banks (all of which do both commercial and investment banking) engage in overly risky practices and have "incestuous" relationships with the other banks and major domestic conglomerates These factors, it is argued, indicate that serious challenges and difficulties are looming on the horizon for the banks and the economy generally.

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The Case that Analysts' Warnings Are Overstated

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¶5. Nonetheless, significant arguments have also been put forward that the threats posed by certain imbalances in the economy, and by extensive international borrowing on the part of the banks, have been exaggerated and misinterpreted, and do not pose the danger many have posited. For example, the high current account deficit is in large part due to the three huge capital investment construction projects currently underway in Iceland -- two huge aluminum smelter facilities (including one owned by Alcoa) and a massive hydroelectric power plant. These projects represent some $2.5 billion being pumped into a $15 billion economy over just a couple of years. When these projects are all completed, sometime during 2007, the current account situation will likely return to normal (from 2000-2003 the average deficit was minus 4 percent). The Krona's recent return to a more realistic level will also help even out the current account deficit by dampening imports.

¶6. It is also pointed out that government debt at 30 percent of GDP is low by most standards (and about half the level as in the U.S., Germany and France). As for inflation, when real estate price increases are removed, the "core" rate of inflation is a mere 1.8 percent. While the banks have indeed been borrowing heavily to finance Icelandic conglomerates' investments abroad, these foreign investments have largely been in non-speculative, low-risk sectors such as banking, pharmaceuticals and clothing and food retailing. Another argument holds that rather than suggesting underlying weakness or instability, the fact that Icelandic banks now find it more difficult (i.e., costly) to tap financing most likely implies the banks will simply have to curtail their recent expansive lending activity and settle for "normal" growth instead of the torrid double- and triple-digit growth rates of the last few years.

¶7. The most compelling analysis offered to date in defense of the Icelandic banks, the soundness of the economy, and the government's ability to handle any financial crisis comes from the well-respected U.S. credit rating firm Moody's. In a report entitled "Iceland's Solvency and Liquidity Are Not at Risk," issued April 4, Moody's offers the following conclusions:

-- "While we have warned of the risks that may accompany increased leverage in the economy, Iceland has our top rating with a stable outlook, and we believe these concerns have recently been exaggerated."

-- "Iceland is a very wealthy country engaged in a major process of economic diversification. It possesses ample sources of alternate external liquidity above and beyond the banks own liquidity positions that should enable the government and banking system to weather a period of market turbulence."

-- "Iceland is well positioned to deal with any potential

claims on government resources that might emanate from a systemic problem in any sector of the economy. Our Aaa rating for Iceland is compatible with such an extreme scenario."

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Government Defends Economy, but Warnings not Ignored
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¶8. While the government has reacted to the current furor by consistently reiterating the message that the economy is sound and there is no need to worry, economic policymakers have also clearly taken some of the warnings on board. For example, the Central Bank raised its official rate by a more-than-expected 0.75 percent (to 11.5 percent) at its last rate-setting meeting. This action sent a signal that the government is indeed determined to rein in inflation, while also helping to ease the decline of the Krona. The Central Bank has also sought to quell market jitters through reassuring statements that Iceland's financial system stands up to all its stress tests. In addition, a new (though long in the works) joint Central Bank-Financial Supervisory Authority committee has been established to watch for signs of weaknesses in the financial sector and to formulate contingency plans for correcting them.

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Consequences of Altered Economic Conditions/Perceptions
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¶9. Comment: Certainly going forward the banks will have to curtail their lending activity now that foreign financiers are less willing to continue extending easy credit. And the Icelandic stock market's phenomenal growth rate will undoubtedly return to more realistic levels now that Icelandic firms will be compelled to take a more incremental approach to foreign expansion in response to changed market conditions. This evolving economic landscape has government forecasters envisioning Icelandic GDP growth going from 6 percent in 2005 to 4.5 percent in 2006, and cooling further to between 0 and 2.0 percent in 2007.

¶10. Comment continued: Given the intense financial media

scrutiny Iceland has been under for the past two months, it can be argued that the country's economy, major conglomerates, banks, and financial markets have actually weathered the storm fairly well (e.g., the currency and stock market declines might have been far worse). As the Wall Street Journal put it in an April 10 article, "The jury is still out on whether it (the current economic turmoil) is anything more than a rough spot." End comment.

van Voorst